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SUBJECT: The GOA's Overly Optimistic 2010 Budget

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¶1. (SBU)Summary: Last month, Parliament approved the 2010 budget. The budget anticipates a growth rate of 6.5 percent (vs 2009 revised budget), revenue growth of 11 percent, a budget deficit of 3.9 percent of GDP and inflation stable at three percent. Even though Albania is one of the few countries with positive economic growth in the region for 2009, the 2010 budget remains overly optimistic both in terms of projected revenues and GDP growth, and will be difficult to accomplish. Based on this budget, unless revenues recover at a record pace in the first half of 2010, the GOA could face severe budget shortfalls by mid-2010. End Summary.

A Mixed Story -------------

¶2. (SBU) The Albanian economy is rare in the region in that it is expected to have positive economic growth this year. In October, the IMF revised upwards its earlier growth forecast of 0.7 percent GDP to 2 percent for 2009 growth, which, despite falling short of the GOA's estimates of 4.5-5 percent, remains an achievement. The strong fiscal stimulus throughout the year, particularly before the June election, is seen as a major contributing factor for the increase.

¶3. (SBU) However, the domestic economy is experiencing a slowdown, mainly due to low trade volume, which has hit public revenues. In September, the government was forced to revise downward the 2009 budget and reduced both revenues and public spending. It appears that even with the revision downward the GOA may be as much as 30 billion lek (315 million USD)short and ministries are being pressured to immediately put off projects until 2010. A large portion of non-entitlement government spending comes at the end of the fiscal year (Jan-Dec 2009.

A Faulty Crystal Ball for Revenues

¶4. (SBU) The 2010 budget projects a growth rate of 6.5 percent, an increase in GDP per capita of 10 percent, and a slight drop in unemployment. Additionally, public revenues are expected to increase by 11 percent. The revenue increase is justified by the GOA through a deepening of structural reforms, mainly in the tax system administration. However, in the 2009 budget revenues were forecast to rise 15 percent (original budget), then 12 percent(revised budget)and may in fact only rise 2-3 percent when actual 2009 revenue figures are published. This means that the GOA would need a revenue growth rate of 20 percent or more compared to actual 2009 receipts to meet their current 2010 targets. In the past ten years the average revenue growth rate has been ten percent, and never exceeded 15 percent.

2010: Roads, Salaries and Pensions

¶5. (SBU) The total budget for 2010 is 4.45 billion USD, which is a 2.5% increase in total spending compared to 2009, but a 15% decrease in capital investment. The fall in capital investment is mainly due to the projected completion of the Durres-Kukes road. (Note: The recent partial collapse of one of the tunnels will likely cause this to be, at least in part, revised. End Note). The GOA's budget continues to focus on modernization of infrastructure (namely a

network of roads). In addition, a graduated (four to 15 percent range)increase in pensions and government salaries and a 20 percent increase in social assistance is planned.

A Budget That Faces Many Challenges

¶6. (SBU) Despite GOA's attempt to convey optimism, there are several challenges that the Albanian economy is expected to face in 2010. The GOA believes that global economic recovery will serve as a boost both for imports and exports. However, the IMF has projected a GDP growth rate of three percent vs GOA's estimate of 6.5 percent. Insecurity over the domestic currency exchange rate and any reduction of consumer demand will not help restore business confidence. The private sector will also face an increase in production costs with electricity prices set to rise 13 percent or more. Finally, the ongoing political strain continues to impact government efficiency and reduce confidence. The opposition, while boycotting Parliament, has harshly criticized the budget as unrealistic in the face of the economic crises.

A Budget in Need of Financing

¶7. (SBU) Financing the budget deficit is another key issue. If 2009 revenue continue to track low there could be a revenue deficit of 30 billion lek for just the last quarter of 2009 (315 million USD) that needs to be covered. The GOA has made a strong push to reduce spending in the last quarter of 2009 and many projects and payments are reportedly being put off in order to make up the potential shortfall. The GOA is near its debt ceiling and other options for covering the anticipated 2009 shortfall and future deficit are; issuing local currency debt, raising international debt, privatizations, or increasing grants from International Financial

Institutions (IFIs).

¶8. (SBU) The 2010 budget anticipates raising 14 billion lek (152 million USD) locally on the domestic debt market, but this will be difficult as bank deposits are still rebounding from previous lows and the interest rate is relatively high, around 9.2 percent, for government issued debt. The budget also plans on a 25 billion lek (equivalent) Eurobond (272 million USD)bringing the total level of financing sought to 39 billion lek (430.5 million USD). The Eurobond will not finance the budget however but is , informally earmarked for paying off the high interest rate 200 million euro syndicated loan that matures in 2012,. Only two major privatizations are left; INSIG (life and non-life insurance) and the GOA's 17 percent share in Albtelecom. (Note: Both privatizations, but particularly INSIG's, have had a serious of starts and stops over the past few years and to privatize both within a year is ambitious. End Note). Grants and loans from IFIs remain a viable option and the Minister of Finance (MOF) has announced that it is in consultations with EBRD, EIB, and the World Bank for additional project financing.

¶9. (SBU)The MOF has also been in talks with international banks about possibly doubling the size of the Eurobond to 50 billion lek (equivalent)(543 million USD). This would allow the government to both pay off the syndicated loan and to use the additional 25 billion lek (272 million USD)to pay for 2010 budget programming. One international bank has passed on the bond as being too large but the MOF is continuing talks with another international bank that has been more receptive.

¶10. (SBU) Comment: The Minister of Finance declared recently that that the worst is over and he expects the economy to rebound next year. This is an ambitious statement that follows an even more ambitious budget. The effects from the crises are still felt in the region, most recently in Greece. The 2009 budget had a similarly ambitious growth and revenue forecast - projections which were not met in the wake of the global economic crisis and aggressive pre-election spending. However, the GOA was able to make up much of

the shortfall through a number of big-ticket privatizations, which altogether brought in nearly 293 million USD. The GOA is cutting 2009 spending deeply to try to reduce the expected shortfall, but it remains to be seen what portion they are able to cover through a mix of delayed spending and outright cuts. At this point, the bigger concern remains the 2010 budget. Projected revenues for 2010 are unrealistically high, and there are relatively few viable or simple privatizations left to make to cover any shortfall. The GOA has put itself in a difficult position of setting expectations unreasonably high, which could force future budget revisions and potential political backlash if it is not able to realize its budget projections.

JONES